[JOINT COMMITTEE PRINT]

DESCRIPTION OF CERTAIN BILLS AND DISCUSSION OF ISSUES RELATING TO SECTION 89 NONDISCRIMINATION RULES APPLICABLE TO CERTAIN EMPLOYEE BENEFIT PLANS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON MAY 9, 1989

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on May 9, 1989, on issues relating to the nondiscrimination requirements for certain employee benefit plans contained in section 89 of the Internal Revenue Code. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law section 89 rules, a description of certain introduced bills relating to section 89, and a discussion of related issues.

The first part of the pamphlet is background and a summary of present-law section 89 rules and a summary of certain bills. The second part is a more detailed description of present-law section 89 rules. The third part discusses issues related to nondiscrimination rules for employer-provided accident or health plans, and the fourth part is a description of the provisions of various bills relating to section 89.

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[1] This pamphlet may be cited as follows: *Description of Certain Bills and Discussion of Issues Relating to Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans* (JCS-10-89), May 8, 1989.

I. BACKGROUND

Purposes of section 89

Section 89 was enacted as part of the Tax Reform Act of 1986, and became effective generally for plan years beginning after December 31, 1988. The statute imposes nondiscrimination and qualification rules with respect to certain employer-provided fringe benefit plans. Rules similar to those enacted as section 89 were originally included in the tax reform proposals submitted to the Congress by President Reagan in May 1985.[2] After enactment in the Tax Reform Act of 1986, the section was the subject of significant modification under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

Section 89 was enacted to limit the tax expenditure related to employer-provided health coverage in certain circumstances. Employer-provided health coverage generally is excludable from the gross income of the employee receiving the coverage. This tax-favored treatment reduces the Federal income tax base and, therefore, reduces Federal budget receipts. The annual cost to the Federal Government of this exclusion is estimated to be $32.6 billion for fiscal year 1990, and the cost is projected to increase to $50.8 billion for fiscal year 1994.[3]

In enacting the Tax Reform Act of 1986, the Congress determined that the substantial cost related to employer-provided health insurance coverage is justified only if the tax benefits fulfill important public policy objectives. Increasing health coverage among rank-and-file employees who otherwise would not purchase or could not afford such coverage was identified as a primary policy objective underlying the exclusion for employer-provided health care coverage. Conversely, the Congress believed that the cost to the Federal Government of employer-provided accident and health coverage is not justified if such coverage disproportionately benefits highly compensated employees. In order to achieve this objective, nondiscrimination rules were enacted to permit the full exclusion from income of employer-provided health benefits only if the benefits are provided to required levels of nonhighly compensated employees and the level of benefits provided to highly compensated employees on average does not disproportionately exceed the average benefits provided to rank-and-file employees.

Present law

Under present law, section 89 applies nondiscrimination rules to certain types of fringe benefit plans, including employer-provided

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[2] The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985.

[3] See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1990-1994*, JCS-4-89 (February 28, 1989).

health plans. There are two different methods of testing for nondiscrimination: a 4-part test and a 2-part test. An employer is not required to test under both methods and may elect either method of testing.

Under the first method of testing, four requirements must be satisfied. First, at least half of the employees eligible to participate in the plan must be rank-and-file employees. This test is designed to limit the tax-favored treatment of plans primarily covering highly compensated employees (e.g., executive-only plans).

Second, at least 90 percent of the rank-and-file employees must have available to them coverage that is at least one-half (50 percent) as valuable as the most valuable coverage available to any highly compensated employee. This test is designed to ensure that a significant percentage of rank-and-file employees have a minimum benefit available to them. For example, if the most valuable coverage available to any highly compensated employee is worth $1,000, then to pass this test, 90 percent of the rank-and-file employees must have available coverage of at least $500.

The third requirement is that the value of coverage received by rank-and-file employees must be at least 75 percent of the average value of coverage received by highly compensated employees. This test is designed to ensure that rank-and-file employees actually receive a significant portion of the tax benefits spent for health coverage.

Finally, under the 4-part test, the plan may not contain any provision relating to eligibility to participate that discriminates in favor of highly compensated employees (the nondiscriminatory provisions test).

As an alternative to the 4-part test, an employer may use a 2-part test. This test was designed primarily to provide a less burdensome method of compliance for small employers. Under this test, two requirements must be met. First, at least 80 percent of the employer's rank-and-file employees must be covered by the plan (or a group of aggregated plans). Second, the plan must satisfy the same nondiscriminatory provisions test as is applicable under the 4-part test.

In addition to the nondiscrimination rules, section 89 contains minimum qualification requirements for health plans (and certain other types of plans). These rules require that a plan must be in writing, legally enforceable, maintained for the exclusive benefit of employees, intended to be maintained indefinitely, and that employees be given reasonable notification of plan terms.

Summary of various bills

S. 654—Senator Pryor

S. 654, the Section 89 Simplification Act, introduced by Senator Pryor and others, on March 17, 1989, modifies several present-law rules contained in section 89 and, in addition, creates a safe harbor from the otherwise applicable nondiscrimination requirements of section 89 in the case of a plan that qualifies as a simplified health arrangement. A plan is a simplified health arrangement if (1) at least 90 percent of an employer's employees are eligible to participate in the plan or a plan of the same type having the same em-

ployer-provided benefit, and (2) the cost to an employee of the plan is not more than $6.70 per week ($348.40 per year) in the case of single coverage and $13.40 per week ($696.80 per year) in the case of family coverage (coverage of the employee and the employee's family).

S. 654 generally is effective for plan years beginning after December 31, 1988.

S. 595—Senator Domenici

S. 595, introduced by Senator Domenici and others on March 15, 1989, delays the application of section 89 for one year (i.e., until plan years beginning after December 31, 1990, makes section 89 inapplicable to certain employers with less than 20 employees, modifies the definition of part-time employees who may be disregarded in applying section 89, and creates an eligibility safe harbor that allows an employer to satisfy section 89 if all nonhighly compensated employees are eligible to participate in a plan as valuable as the most valuable plan available to any highly compensated employee.

S. 595 generally is effective for plan years beginning after December 31, 1988.

S. 89—Senator Symms

S. 89, introduced by Senator Symms and others on January 25, 1989, delays the effective date of section 89 for one year to plan years beginning after December 31, 1989.

S. 350—Senator Lott

S. 350, introduced by Senator Lott and others on February 7, 1989, repeals section 89.

H.R. 1864—Mr. Rostenkowski

H.R. 1864, introduced by Mr. Rostenkowski and others on April 13, 1989, replaces the current section 89 nondiscrimination rules for health plans with a single test. In general, an employer's health program passes the test under the bill if at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week ($520 per year) in the case of individual coverage, or $25.00 per week ($1,300 per year) in the case of family coverage. Further, under the bill, the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee cannot exceed 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

H.R. 1864 generally is effective for plan years beginning after December 31, 1989, with an employer election to apply the provisions of H.R. 1864 with respect to its 1989 plan year.

H.R. 634—Mr. LaFalce

H.R. 634, introduced by Mr. LaFalce and others on January 24, 1989, repeals section 89, effective as if section 89 had not been enacted in the Tax Reform Act of 1986.

II. PRESENT LAW

As enacted by the Tax Reform Act of 1986 and amended by the Technical and Miscellaneous Revenue Act of 1988, Code section 89 has two basic sets of requirements: (1) nondiscrimination rules; and (2) plan qualification requirements. In general, the nondiscrimination rules measure the extent to which health benefits (and certain other types of fringe benefits) are made available to rank-and-file employees and the extent to which such employees actually receive those benefits. These rules basically require an employer to compare benefits provided to highly compensated employees with benefits provided to the rank-and-file employees. These rules are designed to limit tax-favored treatment of employee benefits unless a significant portion of such benefits are provided to rank-and-file employees.

The qualification requirements require health plans (and certain other types of fringe benefit plans) to satisfy certain minimum basic requirements, for example, that the plan be in writing and be legally enforceable.

A. Nondiscrimination Rules

Plans subject to the nondiscrimination rules

In general, health plans and group-term life insurance plans are subject to the section 89 nondiscrimination rules. An employer may also elect to test its dependent care assistance programs under section 89 in lieu of applying the nondiscrimination rules contained in section 129 that otherwise apply to such plans. Disability benefits are subject to the rules to the extent the benefits are excludable from income under section 105 (b) or (c) of the Code. Benefits provided under nonhealth plans may not be taken into account in determining whether the employer's health plans satisfy the nondiscrimination rules.

All employer-provided health coverage is taken into account under section 89. For example, plans providing medical diagnostic procedures or physical examinations are health plans subject to section 89. Health coverage is required to be taken into account under section 89 regardless of the method by which it is provided, for example, through an insurance plan, a self-insured arrangement, or a voluntary employees' beneficiary association (VEBA).

Plans providing for short- and long-term disability benefits, wage continuation benefits, and workers compensation benefits generally are not subject to the section 89 nondiscrimination rules. Similarly, vacation pay plans of the employer are not subject to the section 89 nondiscrimination rules.

The nondiscrimination rules apply to plans maintained by all types of employers, other than plans maintained by churches and certain church-controlled organizations. Thus, section 89 applies to

plans of small and large employers, taxable and tax-exempt employers, private and public employers (including the Federal Government), and plans maintained by more than one employer (i.e., multiple employer and multiemployer plans).

Nondiscrimination tests

There are two methods by which an employer may test its plans to determine compliance with section 89: (1) a four-part testing method, and (2) an alternative, simplified two-part testing method. The employer may choose either testing method, and only needs to use one method, even if use of the other method might lead to different results under section 89.

Four-part test

In general.—The four-part testing method consists of three availability tests and one benefits test. The availability tests measure only whether an employee has the opportunity to participate in a plan. The benefits test measures whether, and to what extent, an employee is actually participating in a plan (i.e., has actually enrolled). The three availability tests are generally referred to as follows: the 90-percent/50-percent test, the 50-percent test, and the nondiscriminatory provision test.

90-percent/50-percent test.—The intent of the 90-percent/50-percent test is to ensure that almost all rank-and-file employees have a reasonably valuable plan available to them relative to the value of benefits available to highly compensated employees. Thus, the rule requires that 90 percent of all rank-and-file employees (i.e., those employees who are not considered highly compensated under the statute) have the opportunity to participate in a plan that is worth at least one-half (50 percent) as much as the plan or plans that provide the greatest value to any highly compensated employee. The value of the coverage to an employee is measured by looking only at the portion of the value that is paid by the employer. Under this test, an employer may look at all health plans to see if the rank-and-file employees have the opportunity to participate in any plan available that meets this requirement. For example, assume that the most valuable health plan available to any highly compensated employee is valued at $1,000. Under the 90-percent/50-percent test, 90 percent of the rank-and-file employees must have the opportunity to participate in a health plan worth at least $500.

50-percent test.—The 50-percent test is designed to limit the tax-favored treatment of plans that are only available to highly compensated employees (e.g., executive-only plans). Under this test, 50 percent of those employees eligible to participate in each option under an employer's health program are required to be rank-and-file employees. For example, assume that the dental plan maintained by the employer is available to 20 employees. The 50-percent test is satisfied if at least 10 of those employees are rank-and-file employees.

Plans of comparable value may be grouped together in determining whether the 50-percent test is satisfied. For this purpose, a group of plans are generally considered comparable if the employer-paid value of the lowest-valued plan is at least 95 percent of the

employer-paid value of the highest-valued plan in the group. For example, suppose an employer maintains two health plans, one with an employer-provided value of $1,000 and one with an employer-provided value of $950. These plans may be treated as a single plan for purposes of the 50-percent test. Thus, for example, these two plans would satisfy the 50-percent test if the only employees eligible to participate in the $1,000 plan are 15 highly compensated employees and the only employees eligible to participate in the $950 plan are 15 or more rank-and-file employees.

Nondiscriminatory provision test.—The third availability test is the nondiscriminatory provision test. Under this test, a plan may not contain any provision relating to eligibility to participate that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. This test is subjective in nature and is intended to be applied in those instances in which discrimination is not easily measured under the numerical nondiscrimination tests. For example, assume that the president of a company has an extremely rare condition that is the primary benefit covered by the employer's health plan. This coverage is provided to all employees, not only the company president. The plan may meet the numerical requirements of section 89 because it covers all employees, not just the company president. However, under the facts and circumstances, the nondiscriminatory provision test may not be satisfied because it is unlikely that anyone other than the company president will ever benefit under the coverage in question.

Benefits test.—The benefits test, which is often referred to as the 75-percent benefits test, is designed to ensure that rank-and-file employees actually receive a significant portion of the total employer dollars that are spent for health benefits. An employer's health plans pass this test if the average value of all employer-provided health coverage received by the rank-and-file employees is at least 75 percent of the average value of employer-provided health coverage received by highly compensated employees. For example, if the average employer-paid portion of health coverage provided to highly compensated employees is $1,000, the 75-percent benefits test is satisfied only if the average employer-paid portion of health coverage provided to rank-and-file employees is no less than $750.

Treasury regulations contain safe harbors for 1989 and 1990 under which an employer does not have to apply the 75-percent benefits test. Instead, the employer may include as taxable income the value of health coverage received by certain highly compensated employees and satisfy certain other requirements.

Two-part test

The alternative method of determining whether an employer's plans are discriminatory is called the two-part test, which consists of the previously discussed nondiscriminatory provision test and an 80-percent coverage test. The 80-percent coverage test was developed for use by small employers with simple benefit programs. An employer passes this test if its plans cover 80 percent of its rank-and-file employees. Thus, for example, if the employer maintains one health plan providing coverage to employees and their families and 80 percent of all rank-and-file employees participate in the plan, then the employer passes the 80-percent coverage test.

Comparable plans may be aggregated for purposes of the 80-percent coverage test. In general, for purposes of the 80-percent test, a group of plans is considered comparable if the employer-paid value of the lowest valued plan is at least 90 percent of the employer-paid value of the highest-valued plan in the group. Thus, for example, a plan with an employer-paid value of $450 and a plan with a similar value of $500 are comparable because $450 is at least 90 percent of $500.

There are several variations on this general comparability rule that compare plans based on employer-provided value. In addition, plans can be aggregated if employees can freely choose among the plans, and the difference in employee cost (i.e., the portion of the cost of coverage that the employee pays) is no more than $100 per year.

Salary reduction contributions

Under present law, special rules apply to pre-tax contributions made by an employee to a cafeteria plan (i.e., salary reduction contributions). In general, except for certain purposes, salary reduction contributions are treated as employer contributions. Special rules apply to the treatment of salary reduction contributions for purposes of the 90-percent/50-percent test and for the 50-percent test. These rules are designed to permit an employer to treat salary reduction contributions as employer contributions if doing so does not permit the avoidance of the tests.

In general, an employer may treat available salary reduction contributions as employer contributions under the 90-percent/50-percent test if the ability to make salary reduction contributions is available on the same basis to rank-and-file and highly compensated employees, and the employer does not offer a benefit to its rank-and-file employees primarily on a salary-reduction basis, while offering the same benefit to highly compensated employees on an employer-paid basis.

Notwithstanding these general rules, the Secretary of the Treasury is authorized to establish rules under which salary reduction shall or shall not be taken into account as an employer-provided benefit to prevent avoidance of the nondiscrimination rules. These rules are to take into account the fact that salary reduction contributions provide a tax-benefit to high-paid employees, but represent employee cost for low-paid employees. Consequently, these rules may also permit salary reduction to be characterized differently with respect to highly compensated and rank-and-file employees.

The exclusion of salary reduction contributions of high paid employees may create inappropriate results if such employees can receive a significant portion of their benefits through salary reduction. For example, suppose a highly compensated employee can purchase $5,000 of health benefits through salary reduction. If salary reduction is disregarded, the employee will be treated as receiving no benefit for purposes of the 90-percent/50-percent test. This treatment is inappropriate because the salary reduction contributions are a significant tax-favored benefit.

On the other hand, the inclusion of salary reduction may create inappropriate results if a significant portion of the rank-and-file are required to purchase a significant portion of their benefits

through salary reduction because at some level of contribution, salary reduction is not effectively available to the rank-and-file because of its cost.

The Secretary of the Treasury has issued regulations providing that, in computing the largest benefit available to a high-paid employee for purposes of the 90-percent/50-percent test, the health coverage attributable to salary reduction is considered an employer-provided benefit and is taken into account to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions (excluding salary reduction).

The regulations also provide that, in computing the benefit available to a rank-and-file employee, core health coverage attributable to salary reduction is considered an employee contribution and is disregarded to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions. This rule only applies when the employer has elected to consider salary reduction as employer contributions for purposes of the 90-percent/50-percent test.

The Treasury regulations also contain a rule relating to salary reduction for purposes of the 50-percent test. In aggregating plans in order to determine the level of benefit for which a nonhighly compensated employee is eligible, salary reduction relating to noncore health coverage generally is not considered available if it exceeds $2,000 unless the employee actually elects a higher amount.

Excludable employees; separate lines of business

In general, all of the employees of the employer, as well as the employees of certain related employers (e.g., subsidiary or affiliate corporations) are required to be taken into account in applying the nondiscrimination tests of section 89. There are, however, several exceptions to this rule.

Separate lines of business or operating units

If the employer has separate lines of business or maintains separate operating units, each separate line of business or operating unit may be tested separately by taking into account only those employees in that line of business or operating unit. In general, if a business location of the employer is located more than 35 miles from another location and meets certain other requirements, that location may qualify as a separate operating unit for section 89 purposes.

Under present law, headquarters employees of an employer generally may not be treated as employed in a separate line of business or operating unit. Special rules apply to determine how such employees are to be allocated to other lines of business or operating units of the employer.

Excludable employees

Certain employees are disregarded in testing for discrimination under section 89. Generally, employees in the following categories are disregarded: (1) employees who normally work less than six months per year; (2) employees who normally work less than 17.5

hours per week; (3) certain nonresident aliens; (4) employees who are under 21 years of age; and (5) employees who have less than one year of service with the employer (or six months with respect to a health plan providing core health coverage).

Some employers have raised the question of whether employees that have been determined to be uninsurable by an insurance company may be disregarded. Section 89 does not allow an employer to disregard such individuals. However, section 89 addresses the issue of uninsurable employees by permitting employers to exclude a significant number of individuals from its health plans and still meet the requirements of section 89.

There is no special definition of what individuals are "employees" for purposes of section 89. Issues arise with respect to whether certain individuals (e.g., prisoners, elected officials, and clients in sheltered workshops) are required to be treated as employees. Whether or not a particular individual is an employee is not determined by section 89 but by other provisions of the Internal Revenue Code. Thus, if an individual is considered an employee under other tax provisions (e.g., employment tax and pension plan rules), they will also be considered to be employees for purposes of section 89 unless the Secretary determines otherwise.

The Secretary, in the preamble to the Treasury regulations issued with respect to section 89, specifically requested comments on the appropriate treatment under section 89 of leased employees, prisoners, clients in sheltered workshops, and similar classes of individuals.

Part-time employees

Generally, if a part-time employee normally works at least 17.5 hours a week, then the employee is required to be taken into account when an employer tests its plans for discrimination under section 89. Section 89 contains a number of exceptions to the requirement that employees who normally work 17.5 hours or more are required to be taken into account. First, the employer may disregard any employee if the employee has coverage under another employer's health plan (e.g., a spouse's plan). In addition, section 89 contains rules that permit an employer to proportionately reduce the coverage it makes available or provides to its part-time employees in relation to the hours worked. Consequently, the employer may still meet the requirements of section 89 even if it does not provide the same level of benefits to its full- and part-time employees, for example, because part-time employees are required to pay more for the same total coverage.

Finally, TAMRA added a special rule relating to part-time employees that is available to small employers (those with fewer than 10 employees). For plan years beginning in 1989, such employers may disregard those employees who work less than 35 hours a week, and for plan years beginning in 1990, the employer may disregard those employees who work less than 25 hours a week. For subsequent plan years, the 17.5-hour rule applies.

Employees covered by a collective bargaining agreement

In general, if any employee covered under a collective bargaining agreement has health coverage, that employee and other employ-

ees in the same bargaining unit are taken into account for purposes of determining whether an employer meets the section 89 nondiscrimination rules. The effect of this rule is that, in most cases, the employer cannot disregard employees covered by collective bargaining agreements.

Family coverage

In enacting section 89, the Congress was concerned that an employer might fail the numerical nondiscrimination tests with respect to health plans covering families simply because those employees with families are disproportionately highly compensated. Therefore, several special rules apply under section 89 with respect to family coverage.

For purposes of the eligibility tests, if the employee has the opportunity to enroll in a plan providing family coverage, such coverage is treated as available to the employee without regard to whether or not the employee actually has a family.

In applying the 75-percent benefits test and the 80-percent coverage test, the employer may test its single coverage and family coverage separately. Thus, if the employee confirms to the employer that he or she does not have a family (e.g., a spouse or dependents), the employer need not consider that employee in testing its family health plans. In addition, if an employee is offered coverage (such as family coverage) at no cost to the employee and the employee declines to participate, that employee may be disregarded for purposes of testing.

Coverage from another employer

The Congress concluded in 1986 that an employer should not fail to satisfy the section 89 requirements merely because an employee declines coverage if the employee has health coverage through another employer (for example, through a spouse's employer). Therefore, employees who confirm to an employer that they have other health coverage may be disregarded in applying the nondiscrimination tests of section 89. If the employer treats employees with families separately as discussed above, then the employer may disregard an employee whose family has other coverage.

Valuation of health coverage

In order for an employer to compare differing health coverages under section 89, the employer must assign a value to each coverage. The Secretary of the Treasury is to establish tables prescribing the relative values of different types of health coverage. Under TAMRA, these tables are to be effective as of the later of (1) the first testing year beginning after the issuance of the tables, or (2) the date specified by the Secretary.

Until the issuance of valuation rules by the Secretary, an employer may use any reasonable method to value its health coverage. For example, the employer may use the cost of the coverage

determined in the same way health coverage cost is determined under the health care continuation rules (sec. 4980B).[4]

There is a special permanent valuation rule for collectively bargained plans maintained by more than one employer (called multiemployer plans). For purposes of section 89, the value of coverage provided by the employer is generally equal to the amount the employer contributes under the collective bargaining agreement on behalf of its employees. Thus, for example, if the contract requires that an employer contribute 55 cents for health coverage for each hour worked by an employee, then the value of the coverage provided to that employee is 55 cents times the number of hours worked.

Testing procedures

Under section 89, an employer chooses a testing year on which to base its testing. Within this year the employer selects a day (called the testing date) on which to determine who are its employees and what coverage is available and provided to such employees. In general, testing is based on the facts in existence on that one date. However, the testing day data is required to be adjusted to reflect changes in plan design and changes in elections by highly compensated employees that have occurred during the year. These adjustments are necessary in order to have the limited data available on the testing day reflect what actually occurred during the year.

Treasury regulations relating to section 89 contain a transition rule for 1989 testing years that permits an employer in certain cases to disregard plan design and election changes that occur prior to July 1, 1989.

Highly compensated employees

A highly compensated employee is an employee who, during the year or the preceding year (1) was a 5-percent owner of the employer, (2) received compensation in excess of $81,720, (3) was an officer of the employer and received compensation in excess of $45,000, or (4) received compensation in excess of $54,480 and was in the top-paid 20 percent of employees. The dollar limits are indexed for inflation. In lieu of calculating the top-paid 20 percent of employees, the employer may elect to treat all employees with compensation in excess of $54,480 as highly compensated employees. An employer is treated as having at least one officer even if that officer has less than $45,000 of compensation.

Former employees

Former employees are taken into account in determining whether an employer meets the requirements of section 89. However, the employer tests former employees separately from active employees. Thus, former employees are not considered when the employer tests its plans relating to active employees. Further, under

[4] In general, the health care continuation rules require that employers provide their employees (and certain other individuals) the opportunity to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. Employers are permitted to charge the individual a specified amount for the coverage, based on the employer's cost of providing the coverage.

TAMRA, an employer is generally permitted to disregard employees who separated from service prior to January 1, 1989.

Sanctions

If an employer's plan fails to satisfy the section 89 nondiscrimination rules, then the highly compensated employees participating in the plan must include in income the value of the portion of the coverage that is discriminatory (the "discriminatory excess"). The discriminatory excess is determined based on the coverage received that is in excess of the coverage that could be provided if the plan were nondiscriminatory. The amount includible in income is based on the discriminatory excess coverage, that is, the premium paid for the coverage, not on the amount of reimbursements received under the plan. Thus, if the nondiscrimination rules are violated, a highly compensated employee is not required to include a greater amount in income merely because he or she was sick during the year.

The employer is subject to an excise tax if the employer fails to report properly on an employee's W-2 the amount includible in the employee's income due to failure to satisfy the section 89 rules. The excise tax does not apply if the failure to report the proper amount was due to reasonable cause.

B. Qualification Rules

In general

The qualification rules of section 89(k) are designed to ensure that a plan meets certain basic minimum requirements. In general, these rules require that a plan be: (1) in writing; (2) maintained for the exclusive benefit of employees; (3) legally enforceable; and (4) established with the intention that it be maintained for an indefinite period of time (the permanence requirement). In addition, an employer must give its employees reasonable notice of the benefits provided under the plan.

Plans subject to the qualification requirements

The qualification rules apply to the following types of benefit plans: (1) health plans; (2) group-term life insurance plans; (3) cafeteria plans; (4) voluntary employees' beneficiary associations (VEBAs); (5) dependent care assistance programs; (6) qualified tuition reduction programs; and (7) fringe benefit programs providing no-additional-cost services, employer-provided eating facilities, and qualified employee discounts.

Writing requirement

Treasury regulations provide that a plan will be considered to be in writing if all material terms of the plan are included or referenced in a single document. No particular format is required and several plans can be included in a single document.

Treasury regulations provide a transition rule relating to this requirement for 1989. Under the regulations, the written document requirement is not required to be satisfied by an employer until the first day of the second year that a plan is subject to section 89.

For example, if a plan has a calendar plan year, that plan need not be in writing until January 1, 1990.

Notice requirement

An employer satisfies the notice requirement by notifying those employees eligible to enroll in the plan of its existence and nature, the group of employees that may be eligible for the plan, the cost and method of enrolling in the plan, and a statement of how an employee can receive additional information about the plan. Under the Treasury regulations, the employer satisfies this requirement if this information is given to employees by the health care provider (e.g., the HMO or insurance company).

Exclusive benefit rule

In general, the exclusive benefit rule requires that the plan is to be maintained for the exclusive benefit of employees and that virtually all individuals participating in the plan are common-law employees of the employer. Self-employed individuals who are treated as employees under the rules relating to qualified retirement plans (sec. 401(c)(1)) are treated as employees for this purpose. Other individuals (i.e., nonemployees) who perform significant services for the employer may participate in the plan, as well as a de minimis number of other individuals, as long as such coverage is provided on an after-tax basis. Under a transition rule, Treasury regulations generally delay the effective date of the exclusive benefit rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

Permanence requirement

Treasury regulations provide that the permanence requirement is satisfied if the plan is established and maintained for at least a consecutive 12-month period. Termination or material modification of the plan before the plan has been in effect for 12 months will not violate the permanence requirement if there is a substantial, independent business reason for the termination or modification, and the termination or modification does not discriminate in favor of highly compensated employees.

Legally enforceable requirement

A plan is considered to be legally enforceable if the conditions required for an employee to participate, receive coverage, and obtain a benefit are definitely determinable under the terms of the plan and an employee satisfying such conditions is able to compel such participation, coverage, or benefit. A plan generally is not considered to be legally enforceable if a decision as to whether to grant or deny participation, coverage, or a benefit is discretionary with the employer.

Under a transition rule, Treasury regulations generally delay the effective date of this rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

Sanction

If a plan fails to satisfy the qualification requirements, then the employer pays benefits under an ad hoc reimbursement program

that attempts to convert fully taxable compensation into nontaxable benefits. Consequently, if such requirements are not met, then all employees participating in the plan are required to include in income the value of benefits (e.g., reimbursements) received under the plan. This sanction may be imposed on all employees whether or not they are highly compensated employees.

Treasury regulations contain several provisions that reduce the sanction for failure to comply with the qualification rules. First, no sanction is imposed if there is a de minimis failure to satisfy the writing or notice requirements, and the failure is corrected within 90 days after the employer has notice of the failure.

Second, the regulations limit the amount includible in income to a percentage of the individual's compensation. In particular, the amount includible for failure to meet the qualification requirements is limited to the sum of (1) 10 percent of the employee's compensation up to the dollar amount used to determine the top-paid 20 percent of highly compensated employees ($54,480 for 1989), (2) 25 percent of the employee's compensation in excess of such dollar amount but not in excess of 200 percent of such dollar amount, (3) 75 percent of the employee's compensation in excess of 200 percent such dollar amount up to and including 300 percent of such dollar amount, and (4) 100 percent of the employee's compensation in excess of 300 percent of such dollar amount. For example, if an employee has $20,000 of compensation and a taxable benefit of $30,000 by reason of a plan's failure to meet the qualification requirements (e.g., the employee had surgery for which the employer paid), the employee would not be required to include in his or her taxable income more than 10 percent of compensation ($2,000).

Third, under the regulations, if a failure to satisfy the qualification requirements is limited to a specific aspect of coverage provided in a plan, then that aspect of coverage may be treated as a separate plan for purposes of determining the amount includible in income. For example, suppose that a benefit is paid to a participant and the benefit exceeds the dollar limitation on benefits described in the written plan. The amount of the benefit in excess of the dollar limitation may, under the circumstances, be treated as a separate plan and, therefore, could be included in the taxable income of the recipient without an adverse impact on the rest of the plan or its participants.

The penalty imposed upon an employer for failure properly to report the amount includible in income on an employee's W-2 applies to failures to report income includible as a result of failure to satisfy the qualification rules of section 89.

C. Effective Date of Section 89 Rules

In general, the nondiscrimination rules and the qualification requirements of section 89 are effective for plan years beginning on or after January 1, 1989. A delayed effective date applies to plans maintained pursuant to one or more collective bargaining agreements. The effect of this delayed effective date is that in applying the nondiscrimination tests, participants in such collectively bargained plans may be disregarded until the delayed effective date at the employer's election. As described above, Treasury regulations

contain transition rules that have the effect of delaying the effective date of certain of the section 89 rules to July 1, 1989. In addition, the Treasury Department announced, on May 1, 1989, that the delay to July 1, 1989, in the regulations would be extended to October 1, 1989.

III. ISSUES

The major issues raised to date under section 89 deal with the rules as applied to employer-provided accident or health plans. Thus, the following discussion relates only to accident or health care coverage.

Complexity; recordkeeping requirements

Many employers argue that the present-law section 89 nondiscrimination rules are overly complex and impose burdensome recordkeeping requirements. For example, if an employer elects to test family coverage separately from individual coverage and to disregard individuals with other coverage, under present law, the employer is required to obtain sworn statements from its employees attesting to the employee's family status and to whether the employee (and his or her family) is covered under a plan of another employer (e.g., a spouse's plan). In addition, regardless of the employer's testing method, the employer has to determine what individuals have elected to participate in each plan of the employer. Some employers do not currently obtain and maintain such information, or do not do so in the systematic manner required to demonstrate compliance with section 89.

Some employers, particularly small employers, argue that the alternatives available in applying the nondiscrimination rules only serve to make the rules more complex.

On the other hand, much of the complexity of the present-law rules is the direct result of the desire of the Congress to allow employers greater flexibility in designing their benefit plans. Because the benefit plans of employers differ greatly in design, various options and elections that employers may use to demonstrate compliance with section 89 are arguably necessary to account for such design differences. Many of the present-law rules, e.g., the rules permitting the separate testing of family coverage and the provisions added in the TAMRA, were the direct result of input from employers and health-care providers who argued that such rules eased the burdens of section 89.

Also, some of the rules adding to the perceived complexity of section 89 are elective on the part of an employer. For example, an employer is not required to test its plans under all possible methods, but may test under any one of the available methods. Thus, the employer may choose to limit the amount of testing to which it is subject under present law.

Some employers have also argued that the lack of a permanent rule for valuing health benefits makes the rules more difficult to apply. Thus, some employers have argued that the temporary valuation rule added by TAMRA should be made the permanent valuation rule.

Possible employer responses to nondiscrimination requirements

Some have argued that the overall effect of the section 89 nondiscrimination rules will be to decrease health insurance coverage of individuals, rather than to promote the expansion of such coverage to those employees who need the coverage the most. Under this theory, for some employers, the costs of compliance with section 89 outweigh the benefits of maintaining employer-provided accident and health plans and, therefore, it is most economical for such employers to eliminate the coverage rather than to comply with the nondiscrimination requirements.

This argument is countered by those who point out that an employer's decision whether or not to maintain a health plan is often driven by the demands of the labor market from which the employer draws. This effect of the labor market is particularly apparent in the case of medium- and large-sized employers who must pay competitive wages and benefits in order to maintain an adequate workforce.

Further, some point out that the response of an employer to nondiscrimination requirements is likely to depend upon the degree to which the employer's plans fail to satisfy the requirements. If the failure to satisfy the nondiscrimination requirements occurs because of the failure to provide an accident and health plan to a relatively small number of employees, an employer may be willing to extend coverage to those employees, thereby satisfying the policy goal of expanded coverage.

On the other hand, if an employer's failure to satisfy the nondiscrimination requirements occurs because of a particularly generous plan provided primarily to its highly compensated employees, the employer may not be willing to eliminate the coverage to satisfy the section 89 rules. In such a case, the employer will include the value of the discriminatory coverage as taxable income on the W-2s of its highly compensated employees and may decide to increase such employees' salaries by the additional tax the employees will pay on the discriminatory benefits. The policy objectives of the nondiscrimination rules are also being satisfied in such a case because the Federal Government is no longer subsidizing health benefits that are disproportionately provided to highly compensated employees.

In the case of small employers, some argue that the demands of the labor market will not be as significant because such employers often draw workers who are not highly skilled or organized. Further, the costs of compliance may be larger as a percentage of total costs of wages and benefits than they would be for larger employers. In such cases, an employer may view the cost of complying with the nondiscrimination requirements as a significant deterrent to the continued maintenance of a health plan.

On the other hand, some argue that, even for small employers, there are advantages to maintaining a health plan at least on an after-tax basis for the benefit of group insurance rates, employee morale, and recruitment and retention of skilled highly compensated employees.

Part-time employees

Many employers argue that the present-law definition of part-time employee (employees who normally work more than 17.5 hours per week) is unduly restrictive, and does not conform to normal business practices in certain industries. They argue that it is unrealistic to expect employers to expand coverage to employees whose health benefits constitute a significant percentage of their overall wages. Moreover, some employers contend that it is currently difficult to obtain insurance for part-time employees.

Because of these problems, some employers have argued that the 17.5-hour standard should be increased, or that the requirement that part-time employees be taken into account should be phased-in over time.

Others argue that part-time employees should be taken into account under the nondiscrimination tests because such employees constitute a significant portion of the individuals without any available health care coverage. They point out that section 89 does not require that an employer provide coverage to part-time employees. Rather, if such an employee does not have coverage (from the employer or another employer, such as under the plan of a spouse), the fact that the employee cannot be ignored reduces the likelihood that the employer can pass the nondiscrimination tests. This result is consistent with one of the general purposes of section 89, which is to reduce the tax subsidy of employer-provided health coverage if an employer has a significant number of nonhighly compensated employees without health coverage (whether from the employer or from another employer).

Further, some argue that one reason that the nondiscrimination requirements do not require an employer to make health plans available to all of its employees is to permit the employer flexibility in determining the classes of employees who are excluded from eligibility for the employer's health plans beyond those classes of employees that are automatically excluded from consideration. Under this argument, the nondiscrimination requirements already take into account the problems employers face with respect to providing health benefits to rank-and-file employees by allowing the employer to offer coverage to less than 100 percent of its workforce and still satisfy the nondiscrimination requirements.

Employees covered by collective bargaining agreements

Under present law, most employers are required to take employees covered by collective bargaining agreements into account in applying the nondiscrimination tests. This requirement can help an employer pass the nondiscrimination tests if the union has bargained for benefits that are generous relative to the benefits provided to the employer's other nonhighly compensated employees. On the other hand, this requirement can make it more difficult for an employer to pass the tests if a significant portion of the employer's employees are covered under a collective bargaining agreement that provides less generous benefits than those generally provided to the employer's other employees.

Some have argued that the collective bargaining process should not affect the employer's other employees and that the benefits

provided outside the bargaining agreement should not affect the employees covered by the agreement. For example, under present law, a highly compensated union employee may be required to include the value of health coverage in income because the employer provides lower benefits to its rank-and-file nonunion employees, even though all union employees receive the same benefits. Some people believe that present law may give a union inappropriate leverage in the negotiation of a collective bargaining agreement if the employer cannot satisfy the nondiscrimination requirements because of the benefits provided to collectively bargained employees. Thus, some people argue that plans maintained pursuant to a collective bargaining agreement should be tested separately from other plans of the employer. Such a rule would be more consistent with the treatment of union employees under the rules applicable to qualified pension plans.

Others argue for the present-law rule relating to the treatment of collectively bargained employees. Some employers prefer the present-law rule because it aids them in meeting the requirements of section 89. Some argue that the leverage the present-law rule may give the union is appropriate. Requiring union employees to be taken into account may serve to increase the level of coverage of such employees, which is consistent with the general purposes of section 89.

The present-law rule may reduce the level of discrimination in some cases. For example, if an employer's nonunion employees are all highly compensated, then present law would generally prevent the employer from providing a disproportionately high level of benefits to the highly compensated employees. If the union employees are tested separately, however, then there is no limit on the tax-favored benefits that can be provided to the highly compensated employees.

Some also argue that benefits provided pursuant to collective bargaining agreements should not be subject to the nondiscrimination rules. Proponents of this view argue that the operation of the collective bargaining process is sufficient to deal with the policy purposes of section 89 and that the nondiscrimination rules should not be allowed to influence the collective bargaining process. They argue that an exemption is particularly appropriate in the case of multiemployer plans (i.e., plans maintained by more than one employer). Under this view, recordkeeping presents particular problems in the case of such plans, because the employer may not know what the benefits are under the plan, or whether an employee is eligible to participate in the plan. However, many of the recordkeeping problems under present law were addressed in TAMRA.

Opponents of an exemption argue that there is no policy justification for exempting collectively bargained plans from nondiscrimination rules. At the very least, tax benefits should be limited if the benefits under the agreement discriminate in favor of high-paid collectively bargained employees if the collectively bargained plan is tested separately.

Leased employees

Under present law, in applying the nondiscrimination tests, an employer is required to take into account certain individuals who

perform services for the employer, other than the common-law employees of the employer. These individuals, called leased employees, are generally defined as individuals who perform services for the employer of the type normally performed by an employee on a substantially full-time basis, even though the individual is nominally employed by another employer. Leased employees must be taken into account by an employer for purposes of the nondiscrimination rules applicable to qualified retirement plans as well as the section 89 rules.

The leased employee rules are designed to prevent circumvention of the nondiscrimination rules. For example, suppose a doctor maintains a health plan for himself, but does not cover his nurses or his office administrative staff (e.g., a secretary). Instead of directly employing his nurses and administrative staff, he leases them from a leasing organization. Without the leasing rules, the doctor would be able to exclude his nurses and staff from the doctor's benefit plans, and provide generous benefits to himself, even though the nurses and staff work only for him and work on a substantially full-time basis.

Many employers argue that taking their leased employees into account under section 89 creates significant administrative problems. Their main concern is that it is difficult to identify leased employees because the statute and proposed Treasury regulations contain a broad definition of who constitutes a leased employee. They argue that leased employees should be ignored in applying the nondiscrimination rules.

Others argue that disregarding leased employees would permit employers to avoid the nondiscrimination rules. Moreover, many leased employees have no health coverage. Thus, disregarding leased employees could undermine one of the policy objectives of section 89.

Some alternative modifications to section 89 have been suggested that would deal with employer concerns without undermining section 89's policy objectives, including (1) delaying the effective date of the section 89 rules to leased employees to give the Treasury Department time to develop alternative rules for leased employees, (2) modifying the definition of a leased employee, and (3) providing that leased employees do not have to be taken into account if they are covered by a safe harbor health plan of the leasing organization. The last alternative is similar to the approach under the rules applicable to qualified retirement plans.

Former employees

Some employers do not have the information necessary to apply the nondiscrimination rules to employees who have already separated from service, and thus argue for a delay in applying the nondiscrimination rules to former employees.

Opponents of delay of the rules to former employees argue that recordkeeping requirements for former employees were adequately addressed in TAMRA. Under TAMRA, employees who separated from service prior to January 1, 1989, can generally be ignored for purposes of the nondiscrimination rules. However, employees who separated from service prior to January 1, 1989, may not be disregarded if their benefits are changed; this restriction may reduce

significantly the former employees who may be disregarded because benefit changes are not uncommon.

In addition, some employers argue that it is difficult to maintain records for any former employees and that section 89 will require them to maintain records for all terminated employees. Thus, they argue that the nondiscrimination rules of section 89 should not be applied to former employees.

Those opposed to this view argue that it is appropriate to apply nondiscrimination rules to former employees for the same reasons that nondiscrimination rules are applied to benefits of active employees. For example, without nondiscrimination rules, an employer could provide retiree health benefits only to its retired key executives. Moreover, it is argued that present law permits an employer to impose reasonable age and service requirements on the receipt of benefits by former employees (e.g., attainment of age 55 with 10 years of service). Thus, the employer will not be required to track all of its former employees in order to apply the tests.

Salary reduction arrangements

Many employers maintain plans that permit an employee the choice between receiving cash or purchasing nontaxable benefits, such as health coverage. These plans are generally referred to as cafeteria plans or salary reduction arrangements, and the contributions made by employees to purchase benefits are generally called salary reduction contributions. Salary reduction contributions generally are not included in the taxable income of the employee.

Many employers have adopted cafeteria plans in order to take advantage of the flexibility and tax benefits such arrangements provide to employees. For example, some employers permit employees to pay the mandatory employee premium for health coverage on a salary reduction basis.

A medical reimbursement account (or flexible spending arrangement) is a type of salary reduction arrangement. Under a flexible spending arrangement, the employee can elect the amount contributed to the account, and then use such amounts to purchase health coverage for benefits not otherwise covered by insurance (e.g., to pay deductibles under the health insurance plan or to pay for items that might not be covered by insurance, such as orthodontia expenses). These expenses, if reimbursed through coverage under a flexible spending arrangement, are not included in the taxable income of the employee, notwithstanding the fact that identical expenses paid with after-tax dollars may not have the same tax-favored treatment because medical expenses of individuals are not deductible unless they exceed 7.5 percent of the individual's adjusted gross income.

Some employers and employees like the flexibility of a cafeteria plan because it lets each employee tailor the nontaxable benefits the employee receives to his or her own needs. Further, some employers consider salary reduction arrangements an essential method by which they can shift a portion of the ever increasing cost of health coverage to the employee. These employers argue that they could no longer afford to provide health coverage to their employees without the cost savings they realize through these salary reduction arrangements. Implicit in this argument is the as-

sumption that the employees are willing to bear a cost of benefits on a pre-tax basis that they are unwilling to bear on an after-tax basis.

On the other hand, some argue that, although salary reduction arrangements permit cost shifting, they do not contribute to overall health cost containment. Such arrangements and, in particular, flexible spending arrangements may serve to increase health costs by subsidizing overutilization of health care services, particularly if they permit employees to pay for first-dollar coverage (e.g., coverage below the deductible limit in the insurance policy) on a tax-preferred basis.

In applying nondiscrimination rules to salary reduction contributions, the key issue is whether such amounts should be considered as employee or as employer contributions to an employee benefit plan.

Some argue that the primary impact of salary reduction contributions on an employee depends on whether one is evaluating the affordability of health care for purposes of an eligibility test or is calculating the value of tax-favored benefits an employee actually receives for purposes of a benefits test. Proponents of this view argue that salary reduction contributions affect whether a rank-and-file employee can afford to participate in a plan. They argue that, aside from certain administrative costs, there is little or no cost to the employer in making salary reduction available to employees. In addition, such contributions reduce the cash available to the employee just as employee after-tax contributions do. Moreover, any eligibility rule that looks to whether coverage is meaningfully available to rank-and-file employees could be easily avoided if salary reduction is not taken into account as an employee contribution. Therefore, these individuals argue that salary reduction is properly considered an employee cost for rank-and-file employees for purposes of an eligibility test.

Proponents of this view also argue that it is the highly compensated who can afford to reduce their salaries and take advantage of the tax benefits of a salary reduction arrangement. Further, salary reduction represents significant tax-savings for highly compensated employees. Failure to treat salary reduction as an employer contribution for purposes of a benefits test could lead to abuse of any nondiscrimination rule, because an employer could simply provide all health coverage to highly compensated employees through salary reduction at no additional cost to the employer or the employee.

As an illustration of this point, assume that an employer pays a highly compensated employee a salary of $5,000 a month and a health benefit worth $300 a month, $200 of which exceeds the health benefit that could be provided on a nondiscriminatory basis. The employee's overall monthly compensation is $5,300, $5,200 of which would be taxable under the nondiscrimination test. If salary reduction is not treated as an employer-provided benefit, the employer could make $200 of salary reduction available to the employee, and reduce the employer-provided health benefit from $300 to $100. Thus, the employee would have $5,200 of salary, but $200 would not be taxable because the employee would elect $200 of salary reduction to pay for his health benefit. The employee's over-

all compensation would still be $5,300, $5,000 of which would be taxable, the employer's total compensation costs would be unchanged, and the nondiscrimination requirements would be satisfied. Thus, the nondiscrimination rules would have no effect if salary reduction contributions are not treated as employer-provided benefits.

There are several alternative methods that might be used to deal with the issues relating to the treatment of salary reduction under any health coverage nondiscrimination rule. One approach would be to treat salary reduction amounts as attributable solely to employee contributions or employer contributions. However, as discussed above, such a rule could effectively undermine any nondiscrimination rule.

Alternatively, an approach similar to the approach under present law could be used. (See the discussion of present law above.) This would allow the treatment to vary depending upon the amount of salary reduction available to an individual and the terms under which it is made available. A similar approach might treat all or a portion of salary reduction available to the rank-and-file employees as employer-provided when calculating the amount actually received by the high paid. On the other hand, such an approach might be said to defeat the principle of making available affordable health care coverage.

Another approach would be to recognize as employer-provided the tax savings to the employee achieved through the use of salary reduction. This approach could apply with respect to whether coverage is available to, or received by, an employee. For example, each dollar of salary reduction available to a nonhighly compensated employee could be considered 15-percent employer-provided and 85 percent employee-provided (assuming a 15-percent tax rate with respect to such employee).

Alternatively, salary reduction could be treated solely or partly as employee contributions for purposes of section 89 and the rules relating to cafeteria plans under section 125 of the Code could be tightened in order to ameliorate discrimination concerns under cafeteria plans.

State and local governmental plans

Some argue that the nondiscrimination rules of section 89 present special problems for State and local government employers. For example, such employers generally have large numbers of employees and may not have centralized recordkeeping, making data collection more burdensome. In addition, in some cases it is difficult to identify who the employer is (e.g., the State government or a local government) and thus difficult to determine the proper employee group on which to apply the tests.

Because of these issues, some argue for special rules for State and local governmental plans. Some also argue that such plans should be exempted from the rules. They argue that, because benefits under such plans are often determined pursuant to collective bargaining or State or local law, the benefits are already subject to sufficient scrutiny to ensure that they are nondiscriminatory.

Opponents of an exemption for State and local government plans argue that there is no policy justification for exempting such plans.

Benefits provided under such plans represent a tax expenditure in the same way that benefits provided under plans of private employers do, i.e., the benefits are excludable from income. Thus, nondiscrimination rules should apply to such plans for the same reason these rules should apply to plans of private employers—to limit the tax expenditure unless the benefits are provided on a nondiscriminatory basis. Moreover, it may be more difficult to justify application of the rules to plans maintained by private employers if governmental plans are exempted.

Such individuals argue that, to the extent public employers have specific concerns with the nondiscrimination requirements, such concerns should be directly addressed. For example, if collectively bargained plans are an issue, then any modification of the treatment of such plans in general should also apply to collectively bargained plans maintained by State and local governments.

Qualification rules

The main issue that has been raised with respect to the qualification rules is the sanction for failure to satisfy the rules. Under present law, if a plan fails the qualification rules, then all employees are taxed on the benefits received (e.g., reimbursements for health care) under the plan. This sanction has received considerable attention because of the possibility that a rank-and-file employee could have a large income inclusion if the employee is sick during the year and is covered by a plan that fails the qualification rules. The sanction has been criticized as unfair because it may penalize employees who have no control over, or responsibility for, the failure of the employer to satisfy the rules.

Several alternatives to the present-law sanction have been suggested, including (1) applying the sanction only to highly compensated employees, (2) limiting the amount the of income inclusion (e.g., to a percentage of compensation), (3) limiting the inclusion to the value of coverage in the case of benefits provided through a third-party insurer, and (4) applying the sanction to the employer rather than the employees. An employer sanction could take the form of an excise tax, or the denial of the deduction for the benefits. An excise tax has the advantage that it applies to all employers, not only those that pay income tax.

Some employers have argued that the standards for determining whether a benefit is legally enforceable is not well defined and that, accordingly, it is difficult for an employer to determine whether this qualification requirement is satisfied.

Others counter that the Treasury regulations provided guidance with respect to the standard of legal enforceability that should address the concerns of the majority of employers.

An additional argument relating to the qualification standards that is made by employers is that the exclusive benefit rule is difficult to administer in the case of health plans and is arguably less needed in the area of health benefits than it is with respect to the pension benefits. They also argue that the rule may prohibit the inclusion of individuals who are not employees in an employer's health plan for no legitimate policy reason.

On the other hand, some argue that the justification for the exclusive benefit rule is the same in the case of health benefits as it is for pension benefits.

Repeal or delay of section 89

Some have argued that section 89 should be repealed or delayed in order to give employers more time to adjust to the rules, and the Congress more time to modify the rules. Opponents of repeal or delay argue that the nondiscrimination rules serve to fulfill important policy objectives, and that such objectives should not be abandoned. They argue that it is more appropriate to modify the rules to make them less complex without compromising the basic policy objectives. In addition, repeal or delay would have revenue implications that the Congress would be required to address.

Other issues

Some employer groups have suggested alternatives to the present-law rules other than repeal or delay. Some employers have advocated a design-based nondiscrimination test. A design-based test is one that an employer can satisfy by designing its benefit program in a certain way. Passage of a design-based test is not dependent on individual employee elections as to coverage so that such a test reduces required recordkeeping.

Some employers have also argued that they should be able to avoid testing simply by including the value of coverage in the income of highly compensated employees. It is not clear under present law whether such an approach is permissible.

Some employers have already incurred significant expense to modify their benefit plans to comply with present law. They argue that they should not be disadvantaged by any changes to section 89.

IV. DESCRIPTION OF CERTAIN BILLS RELATING TO SECTION 89

A. S. 654—Senator Pryor

S. 654, the Section 89 Simplification Act, introduced by Senator Pryor and others on March 17, 1989, modifies several present-law rules contained in section 89 and, in addition, creates a safe harbor from the otherwise applicable nondiscrimination rules of section 89 in the case of a health plan that qualifies as a simplified health arrangement.

Nondiscrimination safe harbor

The bill provides that an employer's health program for its employees is considered nondiscriminatory and the employer is not required to test its plan under section 89 if the plan is a simplified health arrangement. A plan is a simplified health arrangement if: (1) at least 90 percent of the employer's employees are eligible to participate in the plan or a plan of the same type having the same employer-provided benefit; and (2) the cost to an employee of a plan is no more than the applicable premium. The applicable premium is $6.70 per week ($348.40 per year) for employee-only coverage, and an additional $6.70 per week for family coverage (i.e., coverage of the employee's family). The applicable premium (i.e., $6.70) is indexed to the cost-of-living adjustments for income tax brackets. However, the applicable premium shall not be less than 5 percent of the minimum wage multiplied by 40 (i.e., 5 percent of the minimum wage calculated on the basis of a 40-hour work week). The qualification requirements of section 89 continue to apply to simplified health arrangements.

Modifications of present-law nondiscrimination rules

Definition of part-time employee

The bill permits an employer to disregard employees normally working less than 30 hours a week in 1989, 27.5 hours a week in 1990, and 25 hours a week thereafter (compared to 17.5 hours per week under present law).

Definition of highly compensated employee

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under the bill, officers with compensation not in excess of $45,000 would not be considered highly compensated employees.

Family coverage

Under present law, an employer may test family health coverage (i.e., coverage of the employee's spouse and dependents) separately

from employee-only coverage for purposes of the 75-percent benefits test and the 80-percent alternative coverage test. When separately testing family coverage, an employer may disregard those employees who do not have families. An employer generally may not disregard an employee from family testing on the ground that the employee has no family unless the employer obtains a sworn statement confirming the family status of that employee. Under the bill, an employer's plan is deemed to satisfy the 75-percent benefits test or the 80-percent alternative coverage test with respect to family coverage if: (1) the employee-only portion of the coverage meets the 75-percent benefits test or the 80-percent alternative coverage test; (2) the family coverage is available on the same basis to both highly and nonhighly compensated employees; and (3) the employee has family coverage available at no more than the applicable premium for a simplified health arrangement (i.e., a maximum premium of $6.70 per week).

Employee cost comparability

Under present law, for purposes of the 80-percent alternative coverage test, two or more plans are generally considered comparable if an employee is eligible to participate in all the plans and the annual difference in cost to an employee among such plans is not greater than $100. This $100 amount is to be increased relative to adjustments in the cost of living. Under the bill, this $100 limit is increased to $365 indexed in the same manner as under present law.

Valuation of health coverage

Under present law, until at least one year after the Secretary issues valuation tables relating to health coverage, an employer may use any reasonable method to value its health plans for purposes of applying the nondiscrimination tests. Under this transition rule, the cost method the employer uses for purposes of determining the applicable premium under the health care continuation rules is generally considered reasonable. The bill makes this transition rule permanent.

Testing date

Under present law, an employer chooses a testing day on which to base its testing under the nondiscrimination requirements for the year. However, data collected on the testing day is required to be adjusted to reflect changes in plan design and changes in elections by highly compensated employees that have occurred during the year. The bill eliminates the requirement that the testing day data be adjusted for changes in elections by highly compensated employees.

Failure to comply with qualification requirements

Under present law, an employer's fringe benefit plans are required to meet certain minimum standards, for example, that the plan be in writing, that employees be notified of plan provisions, and that the plan be maintained for the exclusive benefit of employees. If an employer's plan does not satisfy these requirements, then all employees must include in income the value of benefits

(e.g., reimbursements for health care) received under the plan. The bill modifies the sanction for failure to meet the qualification requirements so that only highly compensated employees are required to include in income the value of the coverage (i.e., the employer-paid premium) relating to the failed plan.

Effective date

The provisions of the bill are effective as if included in the Tax Reform Act of 1986. Thus, the bill is generally effective for plan years beginning after December 31, 1988.

B. S. 595—Senator Domenici

S. 595, introduced by Senator Domenici and others on March 15, 1989, delays the application of section 89 until plan years beginning after December 31, 1990. In addition, the bill makes section 89 inapplicable to any employer who employs less than 20 employees on each day of the year (determined without regard to those employees who are disregarded in applying the nondiscrimination tests).

Under the bill, the definition of part-time employee is amended so that an employer can disregard employees normally working less than 25 hours per week.

The bill creates an eligibility safe harbor that allows an employer to satisfy section 89 if all its nonhighly compensated employees are eligible to participate in a plan as valuable as the most valuable plan available to any highly compensated employee. The value of a plan is determined with respect to the portion of the plan that is paid by the employer. The nondiscriminatory provision test contained in present law continues to apply.

The bill changes the 80-percent alternative coverage test to a 65-percent coverage test.

The provisions of the bill are effective as if included in the Tax Reform Act of 1986. Thus, the provisions are generally effective for plan years beginning after December 31, 1988.

C. S. 89—Senator Symms

S. 89, introduced by Senator Symms and others on January 25, 1989, delays the effective date of section 89 for one year, so that it is effective for plan years beginning after December 31, 1989.

D. S. 350—Senator Lott

S. 350 introduced by Senator Lott and others on February 7, 1989, repeals section 89, effective as if section 89 was not enacted in the Tax Reform Act of 1986.

E. H.R. 1864—Mr. Rostenkowski

H.R. 1864, introduced by Mr. Rostenkowski and others on April 13, 1989, makes substantial revisions to section 89. The bill is intended to reduce significantly the recordkeeping and data collection requirements of section 89 while retaining the policy objectives of the nondiscrimination rules.

Nondiscrimination test

The bill replaces the current section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan passes the bill's test if the plan contains no provision that discriminates in favor of highly compensated employees and the plan satisfies the following requirements:

(1) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week (i.e., $520 per year) in the case of individual coverage, or $25.00 per week (i.e., $1,300 per year) in the case of family coverage (i.e., coverage of the employee and the employee's family); and

(2) the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to as the eligibility test, and the second part is referred to as the benefits test.

Eligibility test

If the employer fails to satisfy the eligibility test, then the value of all health coverage provided to highly compensated employees is includible in the taxable income of the highly compensated employees. For purposes of the limit on mandatory employee contributions (i.e., employee cost) under the eligibility test, amounts paid through salary reduction are treated as an employee contribution. The dollar limits on mandatory employee contributions are indexed for changes in average wage growth.

As under present law, the bill provides that the employer-provided coverage under a plan may be excluded from the taxable income of a highly compensated employee only if the plan does not contain any provision that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. The purpose of the nondiscriminatory provision requirement is to preclude executive-only plans and other inherently discriminatory practices.

Benefits test

Under the benefits test, the maximum coverage that a highly compensated employee may exclude from income generally is 133 percent of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90-percent test. However, if a highly compensated employee elects family core coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90-percent test, then the maximum tax-favored coverage is increased. The maximum coverage for such an employee is 133 percent of the value of the employer-provided benefit relating to family coverage that would otherwise satisfy the 90-percent test if family coverage were separately tested.

Any employer-provided coverage received by a highly compensated employee in excess of the level of employer-provided coverage

that meets the benefits test is includible in the taxable income of such employee.

For purposes of determining the value of the employer-provided benefit received by highly compensated employees under the benefits test, the bill treats salary reduction as employer contributions.

In determining the value of the employer-provided benefit under a plan for purposes of the benefits test, the bill retains present law, including the rules enacted as part of TAMRA. Thus, for example, as under present law, an employer may use premium cost as determined under the health care continuation rules, or can use any reasonable valuation method in lieu of employer premiums until after the issuance of valuation rules by the Secretary. In addition, the special rule for valuation of benefits under multiemployer plans applies.

Election not to test

Under the bill, an employer may elect to forego testing under the nondiscrimination requirements and instead may include the employer-provided benefit for health coverage as taxable income on the W-2 of highly compensated employees.

Part-time employees

Under the bill, employees who normally work less than 25 hours a week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). Mandatory employee premiums may be proportionately increased with respect to those employees that normally work less than 30 hours per week. In such a case, for purposes of the benefits test, the part-time employee is considered as eligible for the same employer-provided coverage as a full-time employee (even though the value of the employer-provided coverage is reduced because the employee pays more for the coverage).

Leased employees

Under the bill, an employer may disregard a leased employee if the leasing company certifies to the employer that such employee has available a core health plan meeting the limitations on mandatory employee contributions contained in the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce.

Employees covered by a collective bargaining agreement

The bill provides that plans maintained pursuant to collective bargaining agreements are tested separately. The rule is to be applied on a bargaining unit by bargaining unit basis.

Former employees

As under present law, the nondiscrimination tests are applied separately to former employees of the employer. The bill delays the application of section 89 to former employees for one year, to 1990. In addition, generally no employee who separates from service prior to January 1, 1990, is to be considered in determining wheth-

er the employer meets section 89 with respect to its former employees.

Definition of highly compensated employee

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under the bill, officers with compensation not in excess of $45,000 will not be considered highly compensated employees.

Plans other than health plans

The bill generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 apply to group-term life insurance. The nondiscrimination rules contained in section 129 as amended by the Tax Reform Act of 1986 apply to dependent care assistance programs.

Failure to comply with qualification rules—excise tax on employer

The bill replaces the present-law sanction for failures to satisfy the plan qualification requirements of section 89 with an excise tax on the employer. The excise tax is equal to 34 percent of the cost to the employer relating to the coverage that failed the qualification requirements. Generally, the cost to the employer is calculated as under the health care continuation rules relating to all coverage under the failed plan.

Effective date

The bill is effective for plan years beginning after December 31, 1989. However, the employer may use either present law or the new rules for 1989. The rule relating to the sanction under the qualification rules and the rule allowing an employer to forego testing are effective for plan years beginning after December 31, 1988.

F. H.R. 634—Mr. LaFalce

H.R. 634, introduced by Mr. LaFalce and others on January 24, 1989, repeals section 89, effective as if section 89 had not been enacted in the Tax Reform Act of 1986.

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